Supreme Court, U.S.
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No.

In The Supreme Court of the United States

OCTOBER TERM, 1998

POLAROID CORPORATION,

Petitioner,

v.

MURIEL K. OFFERMAN, Secretary of Revenue of the State of North Carolina,

Respondent.

On Petition for Writ of Certiorari to the Supreme Court of North Carolina

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PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

I. Whether the North Carolina corporate income tax violates the unitary business principle of the Due Process and Commerce Clauses of the United States Constitution by including in the apportionable income of Petitioner, a multistate nondomiciliary corporation, the judgment damages and interest Petitioner recovered in an out-of-state lawsuit for patent infringement, which lawsuit was not an operational function of its unitary business.

II. Whether the North Carolina corporate income tax violates the Constitution's Due Process and Commerce Clause requirements that a state not tax income out of all appropriate proportion to the business transacted in that state, by increasing Petitioner's apportionable income eleven-fold by including therein the judgment damages and interest it recovered in an out-of-state lawsuit for patent infringement, which lawsuit was not an operational function of its unitary business.

RULE 29.6 LISTING

Petitioner has no parent company or nonwholly owned subsidiaries. It is a member or partner of certain noncorporate entities: 784 Memorial Drive LLC; Polaroid Memorial Drive LLC; Digital Media & Communications LP.

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Polaroid Corporation (herein "Taxpayer") respectfully petitions for a Writ of Certiorari to review the judgment of the Supreme Court of North Carolina in this case.

OPINIONS BELOW

The Opinion of the Supreme Court of North Carolina (Appendix A, *infra* 1a to 34a) is reported at 349 N.C. 290, 507 S. E. 2d 284 (1998), reversing the decision of the North Carolina Court of Appeals found at 128 N.C. App. 422, 496 S. E. 2d 399 (1998) (Appendix B, *infra* 35a to 42a).

JURISDICTION

The Supreme Court of North Carolina issued and filed its opinion on December 4, 1998, and the clerk of that Court is required to "enter judgment and issue the mandate of the court 20 days" thereafter. N.C. Rules of Appellate Procedure, Rule 32(b). The jurisdiction of this Court is invoked under 28 U.S.C. §1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Article 1, Section 8, clauses 1 and 3 of the United States Constitution provide in relevant part:

> The Congress shall have Power To . . . regulate Commerce with foreign Nations, and among the several States, and with Indian Tribes; . . . .

Amendment XIV, Section 1 of the United States Constitution provides in relevant part:

> No State shall make or enforce any law which . . . shall deprive any person of life, liberty, or property, without due process of law; . . . .

Pertinent portions of the North Carolina taxing statutes appear in Appendix D, *infra* 45a to 47a.

STATEMENT OF THE CASE

A. Procedural Background and How the Federal Question Was Presented

Taxpayer sued the North Carolina Secretary of Revenue in the Superior Court in January 1996 for refund of 1991 corporate income taxes paid, complaining that a substantial sum it had received in 1991 in satisfaction of a lawsuit judgment against Eastman Kodak Company ("Kodak") was not apportionable "business income" under the North Carolina statutory definition of that term. The complaint also asserted that the recovery was not taxable by North Carolina under the Due Process and Commerce Clauses of the United States Constitution. The Superior Court allowed the Secretary's summary judgment motion and denied Taxpayer's. Appendix C, *infra* 43a to 44a. The Taxpayer appealed and relied in part in its brief on the Commerce Clause and the Due Process Clause.

The North Carolina Court of Appeals on 20 January 1998 filed its opinion reversing the Superior Court's decision and ruling that the recovery was not "business income" and was not subject to apportionment; the Court did not reach the Constitutional issues. *Polaroid Corporation,* 128 N.C. App. 422; Appendix B, *infra* 35a to 42a.

The Supreme Court of North Carolina reversed, ruling that the recovery was apportionable "business income." The opinion considered and rejected Taxpayer's Constitutional arguments. *Polaroid Corporation,* 349 N.C. 290; Appendix A, *infra* 1a to 34a.

B. North Carolina Corporate Income Tax Scheme

Like most states, North Carolina taxes multistate corporations on an apportioned part of the income from the business conducted within and without the state. The statute does not by its terms employ the Constitutional unitary business principle to identify such income, but rather apportions "business income," defined as follows:

> Business income means income arising from transactions and activity in the regular course of the corporation's trade or business and includes income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitute integral parts of the corporation's regular trade or business operations.

N.C. Gen. Stat. §105-130.4(a)(1), Appendix D, *infra* 45a to 47a.

This definition is essentially identical to that used by numerous states that have adopted the Uniform Division of Income for Tax Purposes Act ("UDITPA").

C. Application of the Taxing Scheme to the Taxpayer

Taxpayer is the inventor of instant photography and holds numerous patents protecting its dominance in manufacturing and selling products in that market. In the 1970's Kodak began to make and market instant cameras,

ending Taxpayer's exclusivity in that market. In 1976 Taxpayer commenced a patent infringement action against Kodak, seeking injunctive relief and damages. In 1985 the court enjoined Kodak, and reserved the issue of damages. *Polaroid Corp. v. Eastman Kodak Co.*, 641 F. Supp. 828 (D. Mass.), *aff'd*, 789 F.2d 1556 (Fed. Cir.), *cert. denied*, 479 U.S. 850 (1986). In 1990 the court determined damages. *Polaroid Corp. v. Eastman Kodak Co.*, 16 U.S.P.Q. 2d 1481 (D. Mass. 1990). In 1991 the court finally awarded damages of $437,523,286, roughly half of which was measured by profits that Taxpayer could have earned from sales lost due to the infringement, and the remainder of which represented an imputed royalty on sales made by Kodak that Taxpayer could not have made even if there had been no infringement. Later that year Taxpayer collected from Kodak the damages, plus $487,003,268 in interest.

North Carolina included the total recovery, damages and interest, in Taxpayer's apportionable "business income," despite these facts: (1) neither the lawsuit nor the recovery occurred in North Carolina; (2) Taxpayer's counsel and activities in connection with the lawsuit were located outside North Carolina; (3) Kodak's use of Taxpayer's patented inventions in laboratories and factories did not occur in North Carolina; (4) Taxpayer did not use the lawsuit recovery in the regular course of its business, for example as working capital, but rather used it to pay taxes on the recovery, repay debt, redeem both preferred and common stock and provide its employees with a special bonus; and (5) the Kodak lawsuit was an "extraordinary transaction" for Taxpayer and Taxpayer had not regularly pursued lawsuits for patent infringement, nor had it ever licensed its core technology to unrelated parties. See Appendix A, *infra* 3a and 8a.

As a result of North Carolina's action, Taxpayer's apportionable "business income" for 1991 increased more than eleven-fold, from $88,021,486 to $1,011,219,410 (and

more than seven times that of the Taxpayer's 1990 year), without any reduction of the percentage used to apportion Taxpayer's "business income" to North Carolina; thus, the assessment also increased Taxpayer's income tax due for 1991 more than eleven-fold. In 1991 0.0634% of Taxpayer's property was located in North Carolina ($1,072,178, which did not include any land or buildings), 0.0605% of Taxpayer's payroll was located in North Carolina ($265,591), and 1.0087% of Taxpayer's sales were in North Carolina ($25,779,258). Record in North Carolina Appellate Courts pp. 40, 160, 195.

D. The Decision Below

The court below determined that Taxpayer's recovery was apportionable "business income" under the second clause of the statutory definition, quoted above, treating the recovery as not arising from an activity in the regular course of Taxpayer's trade or business (indeed, the State never contended that the definition's first clause was met). The court thereby adopted the interpretation of "business income" sought by the *amicus* brief of the Multistate Tax Commission ("MTC"), an organization representing many states that have adopted UDITPA in whole or part.

The opinion below found that the lawsuit and recovery had no connection with North Carolina and that Taxpayer did not utilize the recovery in the regular course of its business in North Carolina. Nevertheless, the opinion stated:

> We hold that once a corporation's assets [there, the patents] are found to constitute integral parts of the corporation's regular trade or business, income resulting from the acquisition, management, and/or disposition

> of those assets constitutes business income regardless of how that income is received.

349 N.C. at 306; Appendix A, *infra* 22a.

The opinion below applied that test to both the damages and interest recovered, and reasoned that the interest was "business income" solely because it arose "from" the patents, which were integral to Polaroid's business. The opinion also invoked an "in lieu of" theory in interpreting "business income," reasoning that the interest was business income:

> [b]ecause the interest portion of the Kodak judgment constituted interest Polaroid received "in lieu of" that which it otherwise would have received from its own investments, ... (emphasis added). . . . The interest represented income lost as a result of Polaroid's being unable to earn interest on the monies it should have received from sales absent the infringement.

349 N.C. 312-13; Appendix A, *infra* 30a-31a.

In rejecting Taxpayer's Constitutional objections, the opinion below attempted to invoke the unitary business principle of *Allied-Signal, Inc. v. Director*, 504 U.S. 768 (1992) by making an erroneous conclusion of law that the recovery was "used as part of Polaroid's working capital and therefore constitute[d] part of Polaroid's unitary business." 349 N.C. at 314-15; Appendix A, *infra* 33a. This conclusion of law is not supported by any evidence and directly conflicts with the opinion's finding of fact that "Polaroid did not utilize the judgment proceeds in the regular course of its business in North Carolina." 349 N.C. at 292; Appendix A, *infra* 3a.

REASONS FOR GRANTING THE PETITION

This petition seeks amplification of this Court's "unitary business principle" as a Constitutional limitation on the UDITPA uniform statute for apportioning "business income" of multistate corporations. It seeks guidance on the meaning of "operational function," a term that this Court introduced in its 1992 *Allied-Signal* opinion, and has not revisited. Without such guidance, states will continue to be in conflict over the scope of the UDITPA definition of "business income," and will continue, as North Carolina has, to expand "business income" beyond the limits of unitary income, and to tax income out of all appropriate proportion to that earned in the state.

I. The Supreme Court of North Carolina Decided a Federal Question in a Way that Conflicts in Principle with Applicable Decisions of This Court, by Apportioning Income Without Requiring that the Income-Producing Activity Be an Operational Function of the Unitary Business.

A. Summary

The opinion below concluded that Taxpayer's lawsuit recovery was apportionable solely because the income "stemmed from" patents that served some operational function in the business. While this is an arguably plausible interpretation of the words of the UDITPA definition of "business income," it conflicts in principle with the opinions of this Court that consistently apply the unitary business principle to assess the business function of the *activities* that produced the income.

The answer to this question is of great national significance, because the UDITPA definition of "business income" is used by the majority of the states and the interpretation promulgated by the MTC was adopted below, as it has been by many (but not all) other states.[1]

B. This Court Does Not Equate the UDITPA Definition of Business Income with Unitary Business Income, but Rather Requires that Apportionable Income Flow from an Operational Function of the Unitary Business.

This Court rejected the request of *amicus curiae* MTC in *Allied-Signal*, 504 U.S. 768 to declare the UDITPA definition of "business income" co-extensive with, and hence a substitute for, the constitutional unitary business principle.[2]

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[1] There is a serious split among the states on the interpretation of the UDITPA definition of "business income." This split is summarized in the opinion below, 349 N.C. at 295-296, Appendix A, *infra* 6a to 7a, noting that the Supreme Courts of Iowa, Kansas and Tennessee require business income to be earned in the regular course of business (enforcing the first clause of the UDITPA definition of "business income"), while the Supreme Courts of Arkansas, Illinois, Oregon and Pennsylvania allow business income also to be earned in any way from property so long as the property's acquisition, management or disposition is integral to the business (reflecting the definition's second clause).

[2] In her dissent in *Allied-Signal* (joined by the Chief Justice and Justices Thomas and Blackmun), Justice O'Connor presumed that the Court's operational function test was at least as broad as the second clause of the UDITPA definition of business income. The problem, as illustrated by this case,

Instead, *Allied-Signal* applied the Constitutional principle that a state can tax only that part of a multistate corporation's income that has a rational relation to the intrastate value of the unitary business conducted in that state and other states. *Allied-Signal* applied the unitary method of determining that relation, whereby the corporation first segregates the income from the unitary business transactions, and then applies certain fractions measuring various contacts with the state in order to apportion to the state a presumably appropriate part of the unitary business income.

Allied-Signal primarily dealt with one form of unitary business income: that received from a payor whose business activities are unitary with the taxpayer. But *Allied-Signal* identified another way to categorize unitary business income: income from an activity that serves an "operational function." 504 U.S. 768, 787.

"Operational function" clearly includes a corporation's regular business activities. That is why this Court has long held such income to be apportionable:

> The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other states. In this it was typical of a large part of the manufacturing business conducted in the state.

Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 120 (1920)

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is that the second clause is broader than the operational function test.

In more complex cases this Court has consistently applied the unitary business principle by asking whether the income reflects profits from the "series of transactions" making up the unitary business. To date this Court has identified three types of operational function income (in addition to income earned directly by the taxpayer in its regular business transactions):

> (1) income that is earned from the taxpayer's own activities in a function that has an "operational" relationship to its regular business activities; *Allied-Signal, Inc.*, 504 U.S. at 787 (referring to working capital);
>
> (2) income that is *both* paid (as in the form of dividends) by a separate entity that conducts part of the taxpayer's unitary business, *and* that "reflect[s] profits derived from . . . [that] functionally integrated enterprise;" *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425, 440 (1980); and
>
> (3) income that is paid by an unrelated purchaser for stock sold by the taxpayer, but similarly reflects profits derived from a functionally integrated enterprise; *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 329 (1982) (involving gain from sale to an unrelated party of stock of another corporation, which gain presumably reflected the unrealized profits of that corporation, but which was not taxable because the corporation was not unitary with the taxpayer).[3]

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[3] The parties in *ASARCO* stipulated that this type of income would be unitary, and the Court agreed without discussion.

C. The Opinion Below Substitutes for this Court's Operational Function Test the UDITPA Test that Requires only a "But For" Relationship Between a Business Asset and the Income.

The opinion below ignores the fundamental point of this Court's unitary business income principle, illustrated above: ask whether the activity that produced the income is a unitary business function. Rather, the opinion below asked only whether the income had a "but for" relationship to a business asset (here, the patents). Because it adopted the MTC interpretation of the UDITPA definition of "business income," the opinion below did not have to fit Taxpayer's judgment recovery into any of the categories of operational function income that this Court heretofore has found to be apportionable.

The opinion below represents but a small variation on the view of New Jersey that this Court rejected in *Allied-Signal*:

> [that] intangible income could be treated as earned in the course of a unitary business if the intangible property which produced that income is "acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business."

504 U.S. at 788-789.

New Jersey at least argued that the purpose of the income production should be business related; North Carolina only argues that an asset having a "but for" relationship to the income be integral to the business.

Just as "investment" property such as stock and short-term securities does not necessarily produce non-apportionable "investment income" under the unitary business principle, so also does "business" property such as patents not necessarily produce unitary business income; but the UDITPA definition mandates that all income "from" property such as Taxpayer's patents be apportioned.

D. The Income at Issue Did Not Reflect Profits Derived from an Operational Function

Taxpayer is not in the business of suing on its patents. The State did not contend and the court below did not find that the Taxpayer's regular business transactions in manufacturing and selling cameras included suing Kodak and recovering nearly a half billion dollars in damages and a greater amount of interest. No decision of this Court extends the unitary business principle to encompass such income. While the lawsuit's claim for injunctive relief served to protect Taxpayer's business, the income was produced by the separate claim for damages, which was not made in a "operational function."

The lawsuit recovery was not a means of realizing income already earned by Taxpayer's unitary business, as occurs when a unitary subsidiary pays a dividend. Rather, the recovery was measured by (1) profits Taxpayer lost, (2) profits Taxpayer could not have earned in its unitary business, and (3) interest that would have been investment income (over half of the recovery).

The opinion below made an erroneous conclusion of law that the recovery was "used as part of Polaroid's working capital." This conclusion conflicts with the factual findings in the opinion that:

> Polaroid did not utilize the judgment proceeds in the regular course of its business in North Carolina. Indeed, the record indicates that Polaroid used the proceeds to pay income taxes, repay debt, redeem both preferred and common stock, and provide its employees with a special bonus.

349 N.C. at 292-93; Appendix A, *infra* 3a.

Furthermore, this conclusion of law, even if correct, would define "working capital" in terms of the actual use of income, as contrasted with the intended user of both the capital and the income. "Working capital" is investments that are short-term because they are made with intent to use the capital and income in the business in the short-term, which the lawsuit here was not. *See Allied-Signal*, 504 U.S. at 787 ("short-term deposits"); *cf.* 26 U.S.C. 993(b)(4) ("money, bank accounts and other similar temporary investments . . . to meet the working capital requirements....").

Moreover, the larger interest portion of the recovery falls squarely into the "investment income" category, which is excluded from unitary business income. The opinion below characterized the interest recovery as in lieu of interest on "investments," and as interest taxpayer might have earned from the investment of its lost profits. Appendix A, *infra* 30a to 31a.

II. Alternatively, the North Carolina Supreme Court Has Decided an Important Question of Federal Law that Has Not Been, But Should Be, Settled by This Court: Do the Due Process and Commerce Clause Requirements that Income Not Be Taxed Out of All Appropriate Proportion to the Business Transacted by the Taxpayer in the State Require

that Apportionable Income Be Earned in the Regular Course of Business.

A. Summary

Taxpayer did not receive the lawsuit recovery from transactions or activities in the regular course of its trade or business. The record shows that including the recovery in "business income," multiplied Taxpayer's North Carolina apportionable income, and tax due, to more than eleven times their original sizes. This distortive inclusion violates the Due Process and Commerce Clauses by taxing income out of all proportion to the business transacted in the state, requiring a ruling either that the state's taxing scheme is inherently flawed, or that it is unconstitutional as applied to the facts of this case.

B. Unconstitutional Gross Distortion of Income Necessarily Results from Apportioning Income Not Earned in the Regular Course of the Unitary Business Functions

In ruling that the UDITPA definition of business income does not require that apportionable income be earned from "transactions and activity in the regular course of the corporation's trade or business," the opinion below removed a limitation on the scope of "business income" that plays an important (if unexamined) role in insuring that income is not taxed out of all proportion to the income earned in the state. *See Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169-70 (1983) (articulating the "external consistency" Commerce Clause test). This Court should settle the question whether the scope of the Constitution's proportionality rule extends beyond the fairness of the apportionment formula, and also limits the pre-apportionment base to income derived from the regular course of the corporation's unitary business functions.

Such a limit is needed because only that series of transactions will consistently produce income that is logically related to the factors employed to apportion part of the unitary income to the State. That is, while the factors of property, payroll and sales logically relate to Taxpayer's income from making and selling photographic equipment, they do not logically relate to its income from a once-in-a-corporate-lifetime lawsuit recovery having no connection with North Carolina.

This Court should amplify the one example it has provided of how a taxpayer can show that a state has taxed its unitary business income out of all proportion to the business transacted in the state: a separate accounting. *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931) (where a 250% increase in the tax base was found distortive). See also *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425, 437 (1980); *Container Corp.*, 463 U.S. at 182 ("the distortive effect of focusing on only one factor [was] so outrageous in a particular case as to require reversal"); *Fargo v. Hart*, 193 U.S. 490, 499-500 (1904); *Norfolk & Western R. Co. v. State Tax Comm'n*, 390 U.S. 317, 327(1968); *Butler Bros. v. McColgan*, 315 U.S. 501, 507 (1942).

C. Alternatively, on the Facts of this Case the Income Taxed Was Unconstitutionally Disproportionate to the Income Taxpayer Earned in North Carolina.

Without determining that the definition of "business income" employed below inevitably results in disproportionate taxation, the Court alternatively should determine that the eleven-fold increase in Taxpayer's tax for 1991 attributable to that definition is unconstitutional.

D. "In Lieu Of" Theory Is Not Relevant Here; this Court's *Safety Car* Opinion Was Misapplied

The lawsuit recovery is not apportionable on the theory that it is "in lieu of" business income. The opinion below utilized this theory, improperly relying on *United States v. Safety Car Heating and Lighting Co.*, 297 U.S. 88 (1936), which only stands for the principle that a claim for patent infringement as of the 1913 effect date of the federal income tax was not then capital, and so the ultimate recovery could be taxed as ordinary income.

In fact, lost profits were only the measure of Taxpayer's damages (in part). This Court has held that the federal income taxability of damages is not necessarily determined by what they are measured by, and the same principle is true here. *See Commissioner v. Schleier*, 515 U.S. 323 (1995) (lost wages can be excludable from federal taxable income under I.R.C. §104(a)(2)).

As to the rest of the recovery, the part measured by imputed royalty was not "in lieu of" unitary income because Taxpayer did not license its technology and would not have earned any such royalties. The interest recovery was in lieu of non-apportionable investment income, as discussed above. *Cf. Brabson v. United States*, 73 F.3d 1040 (10th Cir.), *cert. denied*, 519 U.S. 1039 (1996) (holding that interest on damages for personal injury is not itself damages received on account of personal injury).

While this Court has used an "in lieu of" approach in the federal income tax area to distinguish capital gain from ordinary income, the principal justification for that approach, potentially abusive taxpayer electivity, is not possible here. *See Hort v. Commissioner*, 313 U.S. 28 (1941) (holding that income received in lieu of rent should be treated like rent,

and not capital gain); *Arkansas Best v. Commissioner*, 485 U.S. 212, 222 (1988), (stating that taxpayers should not be able to "transmute ordinary income into capital gain at will."). But Taxpayer here did not transmute anything; it involuntarily was forced to sue to stop a patent infringement, and in the process it recovered damages for the involuntary taking of its property, which damages happened to be measured in part by lost profits.

Finally, the "in lieu of" theory raised in the opinion below obfuscates the fact that the offending UDITPA statute does not contain it, but rather requires (and the opinion requires) only (1) a business role for property that (2) has a "but for" connection to income, in order to (3) apportion the income.

CONCLUSION

The petition for a writ of certiorari should be granted.

This the 1st day of March, 1999.

Respectfully submitted,

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APPENDIX

APPENDIX A

IN THE SUPREME COURT OF NORTH CAROLINA

No. 70PA98

POLAROID CORPORATION

v.

MURIEL K. OFFERMAN
SECRETARY OF REVENUE
OF NORTH CAROLINA

[Filed December 4, 1998]

On discretionary review pursuant to N.C.G.S. §7A-31 of a unanimous decision of the Court of Appeals, 128 N.C. App. 422, 496 S.E.2d 399 (1998), reversing an order entered by Cashwell, J., on 28 February 1997 in Superior Court, Wake County, and remanding for entry of summary judgm1ent for plaintiff. Heard in the Supreme Court 12 October 1998.

Alston & Bird, P.L.L.C., by Jasper L. Cummings, Jr., for plaintiff-appellee.

Michael F. Easley, Attorney General, by Andrew A. Vanore, Jr., General Counsel; George W. Boylan, Special Deputy Attorney General; and Kay Linn Miller Hobart, Asst. Attorney General for defendant-appellant.

Multistate Tax Commission, by Paul Mines, General

Counsel, amicus curiae
WYNN, Justice.

Plaintiff Polaroid Corporation ("Polaroid"), a Massachusetts corporation, develops, manufactures, and sells photographic equipment. As one of the world's predominant manufacturers of instant photographic equipment, Polaroid continually develops and refines methods of designing and I marketing those products. Under this market-leading approach, Polaroid has obtained an extraordinary number of patents; however, it has never licensed its core technology to an unrelated third party.

In 1976, Polaroid sued Eastman Kodak Company ("Kodak") under 35 U.S.C. §271(a) to enjoin Kodak's alleged infringement of Polaroid's patents and to recover damages caused thereby. Approximately nine years thereafter, the United States District Court for the District of Massachusetts ruled for Polaroid, enjoined Kodak, and reserved the issue of damages for later determination. *See Polaroid Corp. v. Eastman Kodak Co.*, 641 F. Supp. 828 (D. Mass. 1985), *aff'd,* 789 F.2d 1556 (Fed. Cir.), *cert. denied,* 479 U.S. 850, 93 L. Ed. 2d 114 (1986).

Following a hearing in 1990, that federal district court resolved the damages issue by deter-mining lost profits to be the primary measure of damages and, as required under 35 U.S.C. §284, by using the alternative "reasonable royalty" measure to set a floor below which the damages could not fall. *See Polaroid Corp. v. Eastman Kodak* Co., 17 U.S.P.Q.2d 1711 (D. Mass. 1991). Accordingly, the final order awarded Polaroid damages of $233,055,432 for "lost profits," an additional $204,467,854 for "lost profits"

determined on the basis of a "reasonable royalty," and prejudgment interest in the amount" of $435,635,685.[1]

As stated, the Kodak lawsuit did not occur in North Carolina. None of Polaroid's property or personnel relating to the Kodak lawsuit was located in this state, nor were any of the infringed-upon patents utilized by Kodak. Moreover, Polaroid did not utilize the judgment proceeds in the regular course of its business in North Carolina. Indeed, the record indicates that Polaroid used the proceeds to pay income taxes, repay debt, redeem both preferred and common stock, and provide its employees with a special bonus.

In 1991, Polaroid classified the Kodak judgment for North Carolina corporate income-tax purposes as "nonbusiness income" under N.C.G.S. §105-130.4(a)(1). Hence, Polaroid allocated the entire judgment to Massachusetts, the state of its commercial domicile. The North Carolina Department of Revenue, however, disagreed with Polaroid's classification of the award as nonbusiness income and therefore reclassified it as business income. This reclassification, in turn, increased Polaroid's North Carolina tax liability by $499,177. After Polaroid objected to the reclassification of the award as business income, an administrative hearing was held before the Secretary of Revenue, who upheld the Department of Revenue's decision. Thereafter, Polaroid tendered the requisite amount and filed this refund action under N.C.G.S. §105-241.4.

The parties filed motions for summary judgment which were heard at the 9 December 1996 Civil Session of the Superior Court, Wake County, before the Honorable Narley L. Cashwell. Judge Cashwell, on 28 February 1997, granted the Secretary of Revenue's motion and denied

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[1] Polaroid ultimately collected $924,526,554, the difference constituting additional postjudgment interest.

Polaroid's. Thereafter, Polaroid' appealed to the Court of Appeals, which reversed the trial court's decision and remanded to the trial court for summary judgment for Polaroid. See *Polaroid Corp. v. Offerman*, 128 N.C. App. 422, 496 S.E.2d 399 (1998).

On 2 April 1998, this Court granted the Secretary of Revenue's petition for discretionary review to decide whether the damages Polaroid received as a result of the Kodak lawsuit constitute business income under N.C.G.S. §105-130.4(a)(1).

I. BACKGROUND

North Carolina is one of seventeen states, which comprise the associate membership of the Multistate Tax Commission, an administrative agency of the Multistate Tax Compact ("Compact").[2] The Compact was created to promote uniformity and compatibility in significant components of state tax systems and to avoid duplicative taxation. *In re Appeal of Chief Indus.*, 255 Kan. 640, 652, 875 P.2d 278, 286 (1994). One of the Commission's central goals is to promote uniformity in the states, taxation of interstate and foreign commerce. Additionally, uniformity among the states with respect to taxation of interstate and foreign commerce constitutes the basis behind the Compact's almost word-for-word incorporation of the Uniform Division of Income for Tax Purposes Act, 7A U.L.A. 331 (1985)

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[2] There are currently twenty-one full-member states of the Multistate Tax Commission. Member states differ from associate-member states in that member states have enacted legislation making the Compact a part of their statutory law. Associate states, on the other hand, though expressing a commitment to the Commission's goals, have not incorporated the Compact into their statutory law.

("UDITPA"). So, given North Carolina's commitment to the Compact and its goal of achieving uniform taxation nationwide it is not surprising that this state's Corporate Income Tax Act is modeled after UDITPA. *See* N.C.G.S. §105-130.4 (1989); *National Serv. Indus. v.* Powers, 98 N.C. App. 504, 391 S.E.2d 509, *appeal dismissed and disc. rev. denied,* 327 N.C. 431, 395 S.E.2d 685 (1990).

Under both the North Carolina Corporate Income Tax Act and UDITPA, a multistate or multinational corporation's net taxable income is divided into two classes: (1) business income which is apportioned among the Compact taxing states according to a three-part formula based upon property, payroll, and sales factors, N.C.G.S. §105-130.4(i); and (2) nonbusiness income which is allocated in a manner whereby it is taxed only by the state with which the asset that generated the income is most closely associated, N.C.G.S. §105-130.4(h). *See National Serv. Indus.*, 98 N.C. App. at 506-07, 391 S.E.2d at 511. Thus, at the threshold, a taxpayer must identify and segregate its "business" income from its "nonbusiness" income. Section 105-130.4(a)(1) of the North Carolina Corporate Income Tax Act defines business income as income arising from transactions and activity in the regular course of the corporation's trade or business and includes income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitute integral parts of the corporation's regular trade or business operations.[3]

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[3] North Carolina's definition of business income is slightly broader than the definition found under the Uniform Act. Specifically, North Carolina's definition reads "acquisition, management, and/or disposition of the property," as opposed to the definition in UDITPA, which uses the conjunction "and" rather than "and/or." Moreover, North Carolina's definition utilizes the term "corporation" instead of

In the case sub *judice,* the parties disagree over the proper construction of the statutory definition of business income. Unquestionably, the first clause of N.C.G.S. §105-130.4(a)(1) and UDITPA – which provides that business income is "income arising from transactions and activity in the regular course of the corporation's trade or business" – sets forth the "transactional test." Under the transactional test, to determine whether business income is derived from a transaction or activity in the regular course of the corporation's trade or business, one must consider the frequency and regularity of similar transactions, the former practices of the business, and the taxpayer's subsequent use of the income. *See National Serv. Indus.,* 98 N.C. App. at 508-09, 391 S.E.2d at 512; *Ross-Araco Corp. v. Commissioner of Bd. of Fin. & Revenue,* 544 Pa. 74, 76, 674 A.2d 691, 693 (1996); *Union Carbide Corp. v. Huddleston,* 854 S.W.2d 87, 92 (Tenn. 1993). Therefore, the central inquiry under the transactional test revolves around the nature of the particular transaction giving rise to the income. *See Union Carbide Corp.,* 854 S.W.2d at 92.

With respect to the statutory definition's second clause – which provides that business income "includes income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitute integral parts of the corporation's regular trade or business operations" – the parties debate whether this clause simply modifies the first clause or whether it sets forth a second, independent test for business income.

Some state supreme courts read the second clause of UDITPA as simply modifying the first clause and therefore

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"taxpayer." These distinctions are irrelevant to the case *sub judice*.

hold that the definition of business income under UDITPA contains only the transactional test. *See, e.g., Phillips Petroleum Co. v. Iowa Dept. of Revenue & Fin.*, 511 N.W.2d 608 (Iowa 1993); *In re Appeal of Chief Indus.*, 255 Kan. 640, 875 P.2d 278; *Federated Stores Realty v. Huddleston*, 852 S.W.2d 206 (Tenn. 1992). However, after these decisions, the legislatures of those states promptly amended their respective tax statutes to explicitly include the functional test within their definition of business income. *See* Act of May 1, 1995, ch. 141, sec. 1, 1995 Iowa Acts 256, 256 (effective retroactive to 1 January 1995); Act of May 17, 1996, ch. 264, sec. 1, 1996 Kan. Sess. Laws 1868, 1868; Act of May 6, 1993, ch. 182, secs. 1, 2, 1993 Tenn. Pub. Acts 442, 442.

Other UDITPA states, however, recognized the second clause as encompassing a second independent test known as the "functional test." *See, e.g., Pledger v. Getty Oil Exploration* Co., 309 Ark. 257, 831 S.W.2d 121 (1992); *Texaco-Cities Serv., Pipeline Co. v. McGaw*, 182 Ill. 2d 262, 695 N.E.2d 481 (1998); *Simpson Timber Co. v. Department of Revenue*, 326 Or. 370, 953 P.2d 366 (1998); *Ross-Araco Corp. v. Commissioner of Bd. of Fin. & Revenue*, 544 Pa. 74, 674 A.2d 691. These states concluded either that the plain language of UDITPA includes the functional test or that the definition of business income is ambiguous, and therefore the respective state supreme courts had the right to construe the statute to include the functional test.

Under the functional test, income is classified as business income if it arises from the acquisition, management, and/or disposition of an asset that was used by the taxpayer in the regular course of business. *See Texaco-Cities*, 182 Ill. 2d at 268, 695 N.E.2d at 484. When determining whether a source of income constitutes business income under the functional test, the extraordinary nature or infrequency of the event is irrelevant. *Id.*

In the instant case, we are called upon to determine whether the second clause of N.C.G.S. §105-130.4(a)(1) should be construed as modifying the first clause, thereby mandating that business income include only those transactions that occur in the regular course of the corporation's business, or whether the second clause encompasses the independent functional test, thereby allowing extraordinary transactions to constitute business income so long as the relevant asset was used by the corporation in the regular course of business. This determination is of particular import in this case because Polaroid's recovery from the Kodak lawsuit constitutes an extraordinary or unusual transaction which provided Polaroid with income from assets – the patents – which are integral parts of its regular trade or business operations.

We note that *National Serv. Indus.*, 98 N.C. App. 504, 391 S.E.2d 509, is the only North Carolina case addressing the "business income" issue. In that case, our Court of Appeals was asked to decide whether income obtained from "safe-harbor leases" of electric-generating equipment constituted business income when the taxpayer was not in the business of generating, leasing, or selling electricity or electrical equipment. *Id.* at 508, 391 S.E.2d at 512. In finding that the income constituted business income under North Carolina's statutory definition, the Court of Appeals stated that the determinative question was "whether the return on [the taxpayer's] investment is an integral part of the (taxpayer's] trade or business." *Id.* The Court then concluded that since the lease arrangement was a means of gaining working capital and increasing cash flow for all of the taxpayer's business operations, it accordingly was an "integral part" of the, taxpayer's business. Id. The Court, however, failed to determine the threshold issue of whether this state's statutory definition of business income includes the functional test. We now address this issue of first impression – whether North Carolina's statutory definition of

"business income" contains the functional test – by using the canons of statutory construction, pertinent administrative rules, and the legislative history surrounding both the Act itself and UDITPA.

A. STATUTORY CONSTRUCTION

Under the canons of statutory construction, the cardinal principle is to ensure accomplishment of the legislative intent. *See L.C. Williams Oil Co. v. NAFCO Capital Corp.*, N.C. App. ___, ____, 502 S.E.2d 415, 417 (1998). To that end, we must consider "the language of the statute . . . . the spirit of the act and what the act seeks to accomplish." *Coastal Ready-Mix Concrete Co. v. Board of Comm'rs,* 299 N.C. 620, 629, 265 S.E.2d 379, 385 (1980). Moreover, undefined words are accorded their plain meaning so long as it is reasonable to do so. *See Woodson v. Rowland,* 329 N.C. 330, 338, 407 S.E.2d 222, 227 (1991). Further, the Court will evaluate the statute as a whole and will not construe an individual section in a manner that renders another provision of the same statute meaningless. *See Williams v. Holsclaw,* 128 N.C. App. 205, 212, 495 S.E.2d 166, 170, *aff'd,* N.C. 504 S.E.2d 784 (1998). Significantly, in matters of statutory construction, an ambiguous tax statute shall be strictly construed against the state and in favor of the taxpayer. *See In re Appeal of Clayton-Marcus Co.,* 286 N.C. 215, 219, 210 S.E.2d 199, 202 (1974).

In this case, Polaroid contends, *inter alia,* that under N.C.G.S. §105-130.4(a)(1), business income "arise(s) from transactions or activit(ies) in the regular course of the corporation's trade or business" and that the phrase "and includes" merely modifies this first clause by providing examples of what fits within the definition. The Secretary of Revenue, on the other hand, argues that the statutory definition of business income contains a compound predicate

and thus encompasses both the transactional test and the functional test.

Under the preceding rules of statutory construction, we cannot agree with Polaroid's contention that the second clause of N.C.G.S. §105-130.4(a)(1) simply modifies that section's first clause by providing examples of business income. First, grammatically speaking, business income constitutes the subject of the sentence, which is thereafter defined by two independent clauses, each with its own verb and subsequent definitional language. In fact, the statute could grammatically be read as stating: "Business income means income arising from transactions and activity in the regular course of the corporation's trade or business, and [business income] includes income from tangible and intangible property . . . ." That is, N.C.G.S. §105-130.4(a)(1) does not contain a misplaced modifier, but rather utilizes a compound predicate to illustrate that "business income" includes the definitions set forth in both the first and second clauses. *See Kroger Co. v. Department of Revenue*, 284 Ill. App. 3d 473, 479, 673 N.E.2d 710, 713 (1996), *appeal denied*, 171 Ill. 2d 567, 677 N.E.2d 966 (1997).

Moreover, the General Assembly's decision to employ different language between the two clauses further demonstrates its intention of defining business income in a manner encompassing both the transactional-test and the functional test. Indeed, the first clause states that business income can arise from "transactions or activity" in the "regular course" of the corporation's "trade or business." N.C.G.S. §105-130.4(a)(1). The second clause, on the other hand, states that business income can arise from "property" which constitutes "integral parts" of the corporation's "trade or business operations." *Id.* Therefore, the triggering events in the first clause-"transactions or activities" – are replaced in the second phrase by the triggering events of "acquir(ing), manag(ing), and/or dispos(ing) of . . . property." Moreover,

the predicate phrase found in the first clause – "in the regular course of the corporation's trade or business" – is replaced in the second clause with "integral parts of the corporation's regular trade or business operations." Accordingly, the second clause contains a definition distinct from that set forth in the first.

Our reading of N.C.G.S. §105-130.4(a)(1) comports with that of other state supreme courts, which have confronted this exact argument with respect to similarly, worded statutes. For example, in *Texaco-Cities Serv. Pipeline Co. v. McGaw*, 182 Ill. 2d 262, 695 N.E.2d 481, Texaco-Cities argued that income is business income only if it arises from transactions and activities occurring in the regular course of the taxpayer's business. The Supreme Court of Illinois, in rejecting this argument, stated:

> The first clause consists of general language encompassing all activity in the "regular course of the taxpayer's trade or business." The second clause enlarges this definition to include income from property, as long as its "acquisition, management, and disposition" constitute "integral parts of the taxpayer's regular trade or business operations."

Id. at 270, 695 N.E.2d at 485 (quoting 35 Ill. Comp. Stat. 5/1501(a)(1) (West 1994)). The court then concluded that the functional test was consistent with the plain language of the statute. *Id.*

Similarly, in *Simpson Timber Co. v. Department of Revenue*, 326 Or. 370, 953 P.2d 366, the Supreme Court of Oregon held that its definition of business income--also

modeled after UDITPA--encompassed the functional test.[4] In *Simpson,* the Oregon court was asked to determine whether monies received by Simpson Timber as compensation for the federal government's condemnation of its timberland and timber constituted business income. *Id.* at 374, 953 P.2d at 368. Simpson Timber argued that because it did not voluntarily dispose of the property, the disposition could not constitute an integral part of its regular business operations. *Id.* at 375, 953 P.2d at 3G9. The Supreme Court of Oregon, in rejecting this argument, construed Oregon's definition of business income as including "[i]ncome from tangible and intangible property . . . 'if' the 'acquisition,' 'management,' 'use,' and 'disposition', of [it] are integral parts of taxpayer's regular business operations." *Id.* at 374, 953 P.2d at 369 (quoting Or. Rev. Stat. §314.610(l) (1987)). The Oregon court concluded that since the timber and the land on which it was growing were assets admittedly acquired and used as integral parts of Simpson Timber's business, the income received from those assets, no matter how acquired, constituted business income. *Id.* at 376, 953 P.2d at 370.

New Mexico also applies an approach which, though utilizing the phrase "use test" instead of "functional test," appears to be consistent with our holding. *See Kewanee Indus. v.* Reese, 114 N.M. 784, 845 P.2d 1238 (1993). In *Kewanee,* the Supreme Court of New Mexico was asked to

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[4] Oregon's definition of business income differs slightly from North Carolina's definition in that Oregon's definition refers to the "acquisition, the management, *use or rental,* and the disposition of property constitut[ing] integral parts of the taxpayer's regular trade or business operations." Or. Rev. Stat. § 314.610(l) (1987) (emphasis added). The addition of "use or rental" to the definition does not change the analysis with respect to whether the second clause of the definition constitutes an independent test for business income.

determine whether rental income received from dragline[5] leases constituted business income when the lessor was an oil and gas company which had no history of leasing or financing assets of any kind. *Id.* at 786, 845 P.2d at 1240. The New Mexico court, in classifying the income as business income, defined the use test as an inquiry into whether the income received constituted a gain beyond mere appreciation from a passive investment. *Id.* at 789, 845 P.2d at 1243. Significantly, the New Mexico court cited a lower court's construction of section 72-15A-17(A) (now codified as N.M. Stat. Ann. §7-4-2), defining business income as including income arising from", situations in which the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." *Id.* at 788, 845 P.2d at 1242 (quoting *McVean & Barlow, Inc. v. New Mexico Bureau of Revenue,* 88 N.M. 521, 522-23, 543 P.2d 489, 490-91 (Ct. App.), *cert. denied,* 89 N.M. 6, 546 P.2d 71 (1975)).

Lastly, we note that our holding is consistent with that of the Supreme Court of Pennsylvania, which found its definition of business income to encompass both the transactional and functional tests. *See Laurel Pipe Line Co. v. Commissioner of Bd. of Fin. & Revenue,* 537 Pa. 205, 642 A.2d 472 (1994). In *Laurel,* the Pennsylvania court partly analyzed the issue of whether its UDITPA-based definition of business income included the functional test by referring to other states' discussion on the issue. *Id.* at 208, 642 A.2d at 475. The Pennsylvania court concluded that the second clause of the definition sets forth an alternative and independent "functional" test by which earnings may be characterized as business income if the earnings arise from the acquisition, management, and disposition of property

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[5] A dragline is a large piece of equipment used in the surface mining of hard minerals.

which constitutes integral parts of the taxpayer's regular trade or business. *Id.* Specifically, the court stated that under the functional test, the gain arising from the sale of an asset will be classified as business income if the asset produced business income while it was owned by the taxpayer. *Id.* at 210, 642 A.2d at 475.

In reaching a conclusion contrary to both this Court's and other state supreme courts' rulings, our Court of Appeals relied upon a 1917 probate case, *Miller v. Johnston,* 173 N.C. 62, 69, 91 S.E. 593, 597 (1917), wherein this Court interpreted the phrase "including the five front half-acre lots" in a manner such that the term "including" could not be construed as "in addition to." The Court of Appeals improperly relied upon this holding.

First, *Miller* involved discerning the intent of a devisee, not statutory construction. Moreover, this Court construed the modifying term "including," not the conjunctive phrase "and includes" at issue here. Notably, subsequent to *Miller,* this Court stated that the word "includes," as set forth in this state's Turnpike Authority Act, indicates the General Assembly's intention to enlarge, not limit, the statutory definition. *See N.C. Turnpike Auth. v. Pine Island, Inc.*, 265 N.C. 109, 143 S.E.2d 319 (1965); *see also Baker v. Chavis,* 306 S.C. 203, 208-09, 410 S.E.2d 600, 603 (1991) (concluding that the phrase "shall include" indicates an intent to enlarge the statutory definition, not limit it). Therefore, we conclude that the Court of Appeals erroneously relied on our prior ruling in *Miller* when it determined that the phrase "and includes" cannot be read as meaning "in addition to."

Given our determination that the plain language of N.C.G.S. §105-130.4(a)(1) encompasses both the transactional test and the functional test, we now focus upon the second clause's plain language to define the functional

test. First, we note that the phrase "acquisition, management, and/or disposition" contemplates the indicia of owning corporate property. *See Texaco-Cities,* 182 111. 2d at 270, 695 N.E.2d at 485. Moreover, Webster's Dictionary defines "integral" as meaning "essential to completeness." *Merriam-Webster's Collegiate Dictionary* 607 (10th ed. 1993). Therefore, reading the second clause as a whole, business income includes income obtained from acquiring, managing, and/or disposing of property, which is essential to the corporation's business operations.

In sum, both the general rules of statutory construction and the plain language of N.C.G.S. §105-130.4(a)(1) lend support to the conclusion that this state's definition of business income for corporate income-tax purposes includes both the transactional test and the functional test. To hold otherwise would be to improperly read the conjunctive phrase "and includes" as the modifying term "including." Moreover, it would ignore general rules of grammar and syntax by displacing business income as the overriding subject for that section. *See Valentine* v. Gill, 223 N.C. 396, 398, 27 S.E.2d 2, 5 (1943) ("we need hardly go much further than the grammatical construction and syntax of the law to find its meaning").

B. ADMINISTRATIVE RULE 17 NCAC 5C .0703

We find further support for our ruling in North Carolina Administrative Rule 17 NCAC 5C .0703. "The construction adopted by the administrators who execute and administer a law in question is one consideration where an issue of statutory construction arises." *John R. Sexton & Co. v. Justus,* 342 N.C. 374, 380, 464 S.E.2d 268, 271 (1995). This Court has said that such construction is "strongly persuasive" and therefore is entitled to "due consideration." *See Shealy v. Associated Transp., Inc.,* 252 N.C. 738, 742,

114 S.E.2d 702, 705 (1960). Indeed, "an interpretation by the Secretary of Revenue *is prima facie* correct. When the Secretary of Revenue interprets a law by adopting a rule or publishing a bulletin on the law, the interpretation is a protection to the officers and taxpayers affected by the interpretation." *In re Petition of Vanderbilt Univ.*, 252 N.C. 743, 747, 114 S.E.2d 655, 658 (1960); *see* N.C.G.S. §105-264 (Supp. 1994).

Since the inception of the North Carolina Corporate Income Tax Act, the Secretary of Revenue has adopted the UDITPA approach of defining business income to include both the transactional test and the functional test. The UDITPA approach has been reflected in the Secretary of Revenue's administrative rules since 1976 and is currently set forth in North Carolina Administrative Rule 17 NCAC 5C .0703 – labeled "Business and Nonbusiness Income" – which provides in pertinent part.

> The classification of income by the labels customarily given them, such as interest, rents, royalties, capital gains, is of no aid in determining whether that income is business or nonbusiness income. The gain or loss recognized on the sale of property, for example, may be business income or nonbusiness income depending upon the relation to the taxpayer's trade or business:
>
> . . . .
>
> (2) A *gain or loss from the sale, exchange or other disposition of real or personal property constitutes business income if the property while owned by the taxpayer was used to produce business income* . . .

. . . .

> (5) Patent and copyright royalties are business income if the patent or copyright was created or used as an integral part of a principal business activity of the taxpayer.

17 NCAC 5C .0703(2), (5) (June 1998) (emphasis added). The plain language of this rule clearly demonstrates the Secretary of Revenue's interpretation of business income as encompassing the functional test. Moreover, Polaroid has failed to produce sufficient evidence to rebut the presumption that the Secretary of Revenue's interpretation is *prima facie* correct. Therefore, we conclude that rule 17 NCAC 5C .0703 further supports our holding that business income, as defined under the North Carolina Corporate Income Tax Act, includes the functional test.

Further, it is significant that the Secretary of Revenue's interpretation, as codified in rule 17 NCAC 5C .0703, has remained virtually unchanged for over twenty years. On the other hand, the General Assembly has revised the North Carolina Corporate, Income Tax Act numerous times, and the specific statute at issue in the case sub *judice* has been amended six times. *See* Act of June 18, 1982, ch. 1212, 1981 N.C. Sess. Laws (Reg. Sess. 1982) 108, 108 (clarifying when a corporation may apportion part of its net income or net loss to another state); Act of Aug. 13, 1987, ch. 804, sec. 2, 1987 N.C. Sess. Laws 1G95, 1695 (providing for apportionment of business income of an air or water transportation corporation); Act of June 27, 1988, ch. 994, sec. 1, 1987 N.C. Sess. Laws (Reg. Sess. 1988) 176, 176 (amending the formula used to apportion the income of multistate corporations to this state for income taxation and to conform the formula for payment of estimated taxes to the

federal formula); Act of July 24, 1993, ch. 532, sec. 12, 1993 N.C. Sess. Laws 2239, 2264 changing mandatory language to permissive); Act of June 29, 1995, ch. 350, sec. 3, 1995 N.C. Sess. Laws 828, 829 (making conforming changes to tax law in light of federal law preempting state regulation of most motor freight carriers); Act of Aug. 2, 1996, ch. 14, sec. 5, 1995 N.C. Sess. Laws (2d Extra Sess. 1996) 589, 592 (reforming unconstitutional tax provisions). We reiterate that the legislature is always presumed to act with full knowledge of prior and existing law and that where it chooses not to amend a statutory provision that has been interpreted in a specific way, we may assume that it is satisfied with that interpretation. See *State v. Benton*, 276 N.C. 641, 658-59, 174 S.E.2d 793, 804-05 (1970). We further reiterate that "long acquiescence in the practical interpretation of a statute is entitled to great weight in arriving at its meaning." *State v. Emery*, 224 N.C. 581, 587, 31 S.E.2d 858, 862 (1944). Thus, the absence of any pertinent amendment for so long a period, especially given the General Assembly's willingness to amend other provisions of the Corporate Income Tax Act, indicates legislative approval of the Secretary of Revenue's construction of the statute.

In summation, we conclude that the Secretary of Revenue's interpretation of business income as defined under N.C.G.S. §105-130.4(a)(1) is entitled to due consideration and considered prima facie correct. This *prima facie* presumption is significant given Polaroid's failure to adequately rebut the' Secretary of Revenue's interpretation. Moreover, the General Assembly's failure to amend N.C.G.S. §105-130.4(a)(1) demonstrates its implied acquiescence in the Secretary of Revenue's interpretation, thereby providing further support for our conclusion that the North Carolina Corporate Income Tax Act defines business income in a manner encompassing both the transactional and functional tests.

C. LEGISLATIVE HISTORY

Additional support for our determination that North Carolina's definition of business income includes the functional test can be found in the legislative history surrounding both the North Carolina Corporate Income Tax Act and UDITPA. In determining the legislative intent behind North Carolina's Corporate Income Tax Act, this Court should consider not only the language utilized by the General Assembly, but also the history, spirit, and goals of the Act. *See Mark IV Beverage, Inc. v. Molson Breweries USA, Inc.*, N.C. App. ___, ___ 500 S.E.2d 439, 442 (1998). Also, because it is well established that the North Carolina Corporate Income Tax Act was based upon UDITPA and prefaced upon meeting the goals of the Multistate Tax Compact, the policies underlying both UDITPA and the Compact lend a better understanding of the meaning behind North Carolina's Act.

UDITPA was designed to apportion among the states 'in which a multistate or multinational corporation does business the fair amount of net taxable business income earned by the corporation's activities in each state. *See Pledger*, 309 Ark. at 262, 831 S.W.2d at 124. UDITPA was needed because the divergence in state tax laws unfairly subjected multistate corporations to tax liability on greater than 100% of their income and debilitated their profit margins by increasing their compliance costs. *Id.* UDITPA was drafted to reduce this diversity and to therefore eliminate the accompanying overtaxation and high compliance costs associated with it.

We note that the uniform definition of business income, as set forth in UDITPA, finds its origins in early California jurisprudence. James H. Peters, *The Distinction Between Business income and Nonbusiness Income*, 25 S. Cal. Tax Inst. 251, 272 (1973). Interestingly, the original draft of

UDITPA failed to distinguish between business and nonbusiness income and was amended to reflect such a distinction only after the State of California suggested the value of such a distinction. *Id.* at 275. Ultimately, the uniform definition of business income was modeled after a proposed definition submitted by John Warren of California to the California State Tax Board in February 1965. *Id.* In that letter, Mr. Warren discussed the allocation of royalty income and stated:

> [W]e felt the treatment of royalties was in conflict with the decisions of the State Board of Equalization . . . which had upheld formula apportionment of such income where the acquisition, management and disposition of the patents or copyrights constituted integral parts of the taxpayer's regular trade or business.

Id. The final draft of UDITPA encompasses this formula apportionment approach and thereby provides for the direct allocation of income only to the extent that such income is classified as nonbusiness income. *Id.; see also Texaco-Cities,* 182 Ill. 2d at 272, 695 N.E.2d at 486 (stating that the test was "adopted directly from the comment underlying the UDITPA11).

Further, in *In re Appeal of Borden, Inc.,* Cal. St. Bd. of Equal., Cal. Tax Rep. (CCH) 1 205-616 (Feb. 3, 1997), the California Board of Equalization was faced with the question of whether the second prong of UDITPA contained the functional test. The Board determined that the uniform definition of business income encompassed the functional test and therefore held that "income from assets which are an integral part of the taxpayer's business is subject to apportionment by formula, regardless of whether the income may arise from an occasional or extraordinary transaction."

Id. at 24, Cal. Tax Rep. (CCH) ¶ 205-616, at 14,897-59. In so ruling, the Board noted the recent rejections of the functional test by two other states but dismissed them as improper because those courts did not consider the fact that the uniform definition was derived from California jurisprudence and did not examine the uniform regulations interpreting the definition. *Id.* at 26, Cal. Tax Rep. (CCH) ¶ 205-616, at 14,897-59. Moreover, the Board noted that these decisions were in direct conflict with the Multistate Tax Commission's regulations. *Id.*

The preceding probe into the policies underlying the drafting of UDITPA convincingly shows that the UDITPA definition of business income encompasses the functional test. As stated, the North Carolina Corporate Income Tax Act was patterned after UDITPA. See *National* Serv. *Indus.*, 98 N.C. App. at 506, 391 S.E.2d at 511. Moreover, the timing of the adoption of the North Carolina Corporate Income Tax Act effective 1 July 1967 illustrates that North Carolina was reacting to the nationwide trend of adopting legislation which increased the uniformity and compatibility of state income tax laws with respect to interstate commerce. Therefore, we conclude that North Carolina embraced both the uniform definition and the national trend and accordingly adopted the functional test as part of its definition of business income.

II. APPLICATION

Given our determination that the North Carolina Corporate Income Tax Act defines business income to include the functional test, we must now consider the question of whether Polaroid's award in the Kodak lawsuit constitutes business income under that test. As stated, Polaroid's damage award comprised three separate categories of relief: (1) $233,055,432 for "lost profits," (2) $204,467,854 for "lost profits" determined on the basis of a "reasonable royalty" as required under 35 U.S.C. 284, and

(3) $487,003,268 constituting prejudgment-and postjudgment interest. We will address the classification of each category respectively.

A. LOST PROFITS

It is undisputed that Polaroid's patents are an "integral part of its regular trade or business operations." Indeed, in its brief, Polaroid notes that Kodak's infringement constituted a "potentially devastating threat to the business' of Polaroid" and that protection of Polaroid's patents was crucial to its ability to carry on its regular trade or business operations. Therefore, the patents can be characterized only as integral income-producing assets.

In the case *sub judice,* the question becomes whether income from these integral assets should be classified as nonbusiness income when that income is obtained as a result of court proceedings, rather than from marketplace sales. We hold that once a corporation's assets are found to constitute integral parts of the corporation's regular trade or business, income resulting from the acquisition, management, and/or disposition of those assets constitutes business income regardless of how that income is received.[6]

First, we note United States Supreme Court jurisprudence indicating that damages recovered by a patentee under 35 U.S.C. §284 constitute compensation for any pecuniary loss suffered and are intended to return the

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[6] We do note, however, that cases involving liquidation are in a category by themselves. Indeed, true liquidation cases are inapplicable to these situations because the asset and transaction at issue are not in furtherance of the unitary business, but rather a means of cessation.

patentee to the same condition in which it would have been had the infringement not occurred. *See Aro Mfg. Co. v. Convertible Top Replacement Co.*, 377 U.S. 476, 507, 12 L. Ed. 2d 457, 480 (1964). Indeed, the Supreme Court has explicitly stated that under the current statutory framework, an infringed-upon patentee can recover only its *damages*, as opposed to recovering profits obtained by the infringer or other monies punitive in nature. *Id.* at 506, 12 L. Ed. 2d at 480.

Using the aforementioned cases for general guidance, we now turn more specifically to two state Supreme Court cases outside of this jurisdiction which more directly guide us to our result. First, in *Simpson Timber*, the Supreme Court of Oregon was asked to determine whether condemnation proceeds resulting from a government taking of timberland and timber constituted business income. *Simpson Timber*, 326 Or. 370, 953 P.2d 366. The Oregon court, in classifying the proceeds as business income, first noted that the ultimate sources of the income were the standing timber and the land upon which it was growing – assets admittedly acquired and used as integral parts of the taxpayer's business. *Id.* at 376, 953 P.2d at 370. The court continued: "[W]hen the timber and land on which it was growing were disposed of by an involuntary sale to the government through condemnation, that disposition was as much an integral part of the taxpayer's regular business operations for purposes of the statutory definition as were the initial acquisition, management, and use of the timberland." *Id.* Thus, the court held that "[w]hether the conditions and terms of that sale were set by law, including constitutional law, does not alter that concept. Nor does it alter the additional fact that the compensation paid by the government for the timberland was compensation paid for property that the taxpayer intended to use to produce business income." *Id.* at 375, 953 P.2d at 369. Therefore, the court implicitly held that income received "in lieu of" prospective profits – income that would normally be

characterized as business income – is considered business income for corporate income-tax purposes.

Similarly, in *Dover Corp. v. Department of Revenue,* 271 Ill. App. 3d 700, 648 N.E.2d 1089, *appeal denied, 163 Ill.* 2d 552, 657 N.E.2d 618 (1995), an Illinois appellate court held that a patent-infringement judgment representing reasonable royalties constituted business income under UDITPA. In so ruling, that court stated that "royalty income does not become nonbusiness income merely because Dover enforced its right to receive such income through litigation." *Id.* at 712, 648 N.E.2d at 1097. That is, the court determined that the patents themselves were integral assets used in Dover's regular trade or business operations, and therefore any income obtained from the assets via the judgment constituted income "in lieu of" profits it would normally have received absent the infringement. Accordingly, since those profits would have been taxed as business income, any monies received "in lieu of" those profits should be taxed similarly.

We find the holdings in Simpson *Timber* and *Dover* persuasive. It is undisputed that the Kodak judgment was designed to compensate Polaroid for Kodak's infringement of its patents. Moreover, it is undisputed that Polaroid's patents were an integral part of its regular trade or business operations. In fact, Polaroid's primary source of income results from the sale of products based upon its patents. Therefore, given that the Kodak judgment constituted "income" stemming from the "acquisition, management, and/or disposition" of Polaroid's integral assets and in lieu of normal marketplace sales, we hold
that it should be classified as business income for North Carolina corporate income-tax purposes.

Further, this Court is guided by United States Supreme Court precedent with respect to taxing litigation

awards. In *United States v. Safety Car Heating & Lighting Co.*, 297 U.S. 88, 80 L. Ed. 500 (1936), the United States Supreme Court held that in patent-infringement cases, compensatory damages representing lost profits should be taxed in the same manner as if the profits were earned in the normal manner. Significantly, both statutory law and United States Supreme Court jurisprudence provide that patent-infringement damage awards are intended to put the infringed-upon party in the same pecuniary position as if the infringement had never occurred. *See* 35 U.S.C. §284 (1981); Aro *Mfg. Co.*, 377 U.S. at 507, 12 L. Ed. 2d at 480. These damage awards implicitly provide infringed-upon parties with the profits they would have received from sales absent the infringement-profits, which undeniably would have been taxable as business income. Since the Kodak judgment constitutes income "in lieu of" profits Polaroid ordinarily would have obtained in the marketplace, we hold that the "lost profits" award fits squarely within the functional test and this state's definition of business income.

B. "REASONABLE ROYALTY"

We now consider whether the portion of Polaroid's judgment, which represents "reasonable royalties," constitutes business income under the functional test. As stated, Polaroid has never licensed out its patents to an unrelated third party, and accordingly, Polaroid has never received royalties as a percentage of its business income. Therefore, Polaroid argues that under the "in lieu of" approach set forth in the preceding section of this opinion, this Court cannot find that the "reasonable royalties" it recovered under the Kodak judgment constituted income "in lieu of" that which it would have received absent Kodak's infringement.

The Secretary of Revenue, on the other hand, argues that North Carolina Administrative Rule 17 NCAC 5C

.0703(5) is directly on point. Under Rule 17 NCAC 5C .0703(5), "[p]atent and copyright royalties are business income if the patent or copyright was created or used as an integral part of a principal business activity of the taxpayer." Therefore, the Secretary of Revenue argues that since there is no dispute that the patents at issue were created and used as integral parts of Polaroid's business, the amount Polaroid received as a reasonable royalty is properly classified as business income. Neither of these arguments guides our determination of this issue.

Instead, we consider the pertinent patent-law statute, 35 U.S.C. §284. Under that statute, a party whose patent is found to be infringed upon is entitled to recover "*damages* adequate to compensate for the infringement, but in no event less than a *reasonable royalty* for the use made of the invention by the infringer, together with interest and costs as fixed by the court." (Emphasis added.) Significantly, section 284 contemplates a distinction between "damages" and "profits" recoverable in a patent-infringement suit: "In patent nomenclature, what the infringer makes is 'profits,' what the owner of the patent loses by such infringement is damages. *Duplate Corp. v. Triplex Safety Class Co.*, 298 U.S. 448, 451, 80 L. Ed. 1274, 1278 (1936).

Prior to 1946, the statutory precursor to section 284, Rev. Stat. §4921, allowed both damages and profits to be recovered. *See Aro Mfg. Co.*, 377 U.S. at 505, 12 L. Ed. 2d at 479. In 1946, however, Congress amended the statute to allow an infringed-upon patentee to recover only "damages." *See* 35 U.S.C. 284; *Aro Mfg. Co.*, 377 U.S. at 505, 12 L. Ed. 2d at 479. The purpose of this change was to ensure that a patentee's recovery was limited only to those "damages" it suffered as a result of the infringement. *Aro Mfg. Co.*, 377 U.S. at 505, 12 L. Ed. 2d at 479. Indeed, prior to this amendment, a patentee could recover not only the damages it suffered as a result of the infringement, but also any *profits*

made by the infringer so as to force the infringer to disgorge the fruits of the infringement. *See General Motors* Corp. *v. Devex Corp.*, 461 U.S. 648, 654, 76 L. Ed. 2d 211, 217 (1983). The patentee could recover those profits even if the infringement itself caused the patentee no harm. *Id.*

As stated, 35 U.S.C. §284 allows the award of a reasonable royalty so long as the amount constitutes "damages" resulting from the infringement. *See Aro Mfg. Co.*, 377 U.S. at 505, 12 L. Ed. 2d at 479. These damages, in turn, are defined as constituting "'compensation for the pecuniary loss [the patentee] has suffered from the infringement, without regard to the question whether the defendant has gained or lost by his unlawful acts.'" *Id.* at 507, 12 L. Ed. 2d at 480 (quoting *Coupe v. Royer,* 155 U.S. 565, 582, 39 L. Ed. 263, 269 (1895)). Moreover, these damages "constitute 'the difference between [the patentee's] pecuniary condition after the infringement and what (its] condition would have been if the infringement had not occurred.'" *Id.* (quoting *Yale Lock Mfg. Co. v. Sargent,* 117 U.S. 536, 552, 29 L. Ed. 954, 960 (1886)). Thus, the pertinent question to be answered when deter-mining damages is "how much had the Patent Holder . . . suffered by the infringement. And that question. [is] primarily: had the Infringer not infringed, what would Patent Holder-Licensee has made?" *Livesay Window Co. v. Livesay Indus.*, 251 F.2d 469, 471 (5th Cir. 1958).

The preceding rules used to determine damages in patent-infringement suits apply in two situations. In the first situation, the patentee exercises its patent rights by granting licenses to others, and the infringer is liable for damages because it acted without a license. *See Marvel Specialty Co. v. Bell Hosiery Mills, Inc.*, 386 F.2d 287, 290 (4th Cir. 1967), *cert. denied,* 390 U.S. 1030, 20 L. Ed. 2d 286 (1968). In this situation, the court will determine a reasonable royalty by inquiring into whether the patentee has established a fixed

royalty. *Id.* If no fixed royalty has been established, the court will thereafter inquire into what constitutes a reasonable royalty given the facts presented. *Id.* The second situation involves those times when the patentee exercises its patent rights through a policy of not licensing out its patents and thereby maintains the patent and any accompanying invention as a close monopoly. I*d.* In this situation, there is no established royalty, and therefore the patentee's damages consist of "the money (the patentee] would have realized from a monopoly if there had been no infringement as, for example, the sales (the patentee] would have made and the profits [the patentee] would have realized, or what would have been a reasonable royalty had the patentee undertaken to grant licenses." *Id.* In either case, if the patentee cannot prove its damages by a sufficient showing of lost profits or the establishment of a fixed royalty, the court must establish a reasonable royalty to provide the patentee with adequate compensation for the infringement. *See Panduit Corp. v. Stahlin Bros. Fibre Works, Inc.*, 575 F.2d 1152 (6th Cir. 1978).

There are two established means of determining a reasonable royalty. The first requires an analysis into the infringer's own internal profit projections and motives. *See TWM Mfg. Co. v. Dura Corp.*, 789 F.2d 895, 898 (Fed. Cir.), *cert. denied,* 479 U.S. 852, 93 L. Ed. 2d 117 (1986). The second, more common, approach involves the construction of a hypothetical negotiation between a willing licensor and a willing licensee. *See Trilogy Communications, Inc. v. Comm Scope Co.*, 754 F. Supp468, 512 (W.D.N.C. 1990); *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970), *modified and aff'd,* 446 F.2d 295 (2d Cir.), *cert. denied,* 464 U.S. 870, 30 L. Ed. 2d 114 (1971). In either case, "the calculation is not a mere academic exercise in setting some percentage figure as a 'royalty.' The determination remains one of *damages* to the injured party." *Fromson v. Western Litho Plate & Supply Co.*, 853 F.2d

1568, 1574 (Fed. Cir. 1988). In reality, this device is a legal fiction designed to compensate when profits are not provable, partly because the patentee decided not to license its patents. Id. Moreover, it comports with the overarching goal of patent infringement damage law to place the patent holder in as good a position as that in which it would have been absent the infringement. *See General Motors Corp.*, 461 U.S. at 655, 76 L. Ed. 2d at 217.

The preceding consideration of the pertinent patent-law statute and relevant case law convincingly demonstrates that the term "reasonable royalty" as set forth in 35 U.S.C. §284, is a legal fiction used to help measure the damages an infringed-upon party is entitled to recover when that party is unable to produce satisfactory evidence of lost profits. Significantly, case law illustrates that "reasonable royalties" are used to return the patentee to the same pecuniary position it would have been in absent the infringement. Indeed, even a cursory reading of the trial court's damages opinion reveals that the trial judge based his "reasonable royalty" decision upon what he believed Polaroid would have earned absent Kodak's infringement. It follows that in those situations where the patentee decides to keep a close monopoly and not grant licenses, the "reasonable royalty" measure, in reality, represents lost profits. *See Marvel Specialty* Co., 386 F.2d at 290. Therefore, in those situations where the patentee decides not to license out its patents, we equate damages recovered under the label "reasonable royalties" with lost profits.

Given our determination that the reasonable royalties equate to lost profits, we accordingly reject Polaroid's argument that this aspect of its recovery cannot be assessed as income "in lieu of" lost profits. Moreover, because this part of the award does not, in reality, represent royalties, we reject the Secretary of Revenue's application of rule 17 NCAC 5C .0703(5). Rather, we hold that Polaroid's

"reasonable royalty" recovery constitutes business income because it is income received "in lieu of" profits that, absent the infringement, would constitute business income and be taxable as such.

C. PREJUDGMENT AND POSTJUDGMENT INTEREST

Lastly, Polaroid contends that any interest it received as a result of the Kodak judgment does not constitute business income because it "would not have allowed its normal business accounts to be overdue long enough to produce over $450 million in interest." That is, the interest could not consist of income "in lieu of" that which would have been earned absent the infringement. Again, we find Polaroid's argument without merit.

According to the United States Supreme Court, a court determining damages in a patent-infringement lawsuit should ordinarily consider interest "to ensure that the patent holder is placed in as good a position as that in which he would have been had the infringer entered into a reasonable royalty agreement. General Motors Corp., 461 U.S. at 655, 76 L. Ed. 2d at 217. Indeed, the United States Supreme Court has held that an award of prejudgment interest to a patentee was necessary to ensure full, complete, and adequate compensation since the patentee's damages consisted not only of the value of the lost royalty payments, but also of the foregone use of the money between the time of the infringement and the date of the judgment. *Id.; see also Waite v. United States*, 282 U.S. 508, 509, 75 L. Ed. *494, 495* (1931). Thus, United States Supreme Court jurisprudence demonstrates that an infringed-upon patentee's recovery of interest constitutes compensation for income it would have earned absent the infringement--income that would have been taxable as business income had it been obtained in the marketplace as opposed to the courtroom. Because the

interest portion of the Kodak judgment constituted interest Polaroid received "in lieu of" that which it otherwise would have received from its own investments, classifying the interest portion of the judgment as business income fits squarely within our "in lieu of" formula of apportioning damages.

We find further support for our conclusion in North Carolina Administrative Rule 17 NCAC *5C* .0703(3). Under rule 17 NCAC *5C* .0703(3):

> Interest income is business income if the intangible with respect to which the interest is received arises out of or was created by a business activity of the taxpayer and in those situations where the purpose for acquiring the intangible is directly related to the business activity of the taxpayer.

In this case, Polaroid's patents arose out of and were created by Polaroid's business activities. Further, Polaroid's purpose for acquiring the patents is undoubtedly related to its primary business activity of selling instant photographic equipment. Additionally, the interest income at issue arose out of the Kodak lawsuit and accompanying judgment. The interest represented income lost as a result of Polaroid's being unable to earn interest on the monies it should have received from sales absent the infringement. Thus, to the extent that the damage award constitutes prejudgment and postjudgment interest, it is properly characterized as business income.

With respect to Polaroid's argument that it would not have allowed that much interest to accrue in overdue accounts, we note that a decision to award interest in a patent-infringement lawsuit is in the trial court's discretion and will be set aside only if it constitutes an abuse of

discretion. *See General Motors Corp.*, 461 U.S. at 657, 76 L. Ed. 2d at 219. Because Polaroid has failed to produce adequate evidence demonstrating that the trial court abused its discretion, we affirm the amount of the interest awarded.

III. CONSTITUTIONALITY

Finally, Polaroid argues that should we construe N.C.G.S. §105-130.4(a) as including the functional test, then we must conclude that it violates the Due Process Clause of the United States Constitution by taxing income it has no power to tax and that it violates the Commerce Clause by overtaxing corporations doing business in interstate commerce. *See AlliedSignal, Inc. v. Director of Div. of Taxation,* 504 U.S. 768, 119 L. Ed. 2d 533 (1992) (holding a state may not constitutionally tax income unless it is attributable to "business activities" within the state). We find Polaroid's argument without merit.

Under the United States Constitution, a corporation's "entire net income . . . generated by interstate as well as intrastate activities (can] be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs." *Northwestern States Portland Cement Co. v. Minnesota,* 358 U.S. 450, 460, 3 L. Ed. 2d 421, 428 (1959). North Carolina has determined its fair taxable share utilizing a formula, which examines the in-state aspects of a corporation's property, payroll, and sales. *See* N.C.G.S. §105-130.4(i). Moreover, the apportionment formula utilized by North Carolina is the same one the Supreme Court found constitutional in *Butler Bros. v. McColgan,* 315 U.S. 501, 86 L. Ed..991 (1942), and more recently cited with approval in *Container Corp. of America v. Franchise Tax Bd.,* 463 U.S. 1S91 77 L. Ed. 2d 54S (1983).

Furthermore, to successfully challenge the constitutionality of a state's apportionment scheme, a

taxpayer must demonstrate by "clear and cogent evidence" that the scheme results in extraterritorial values being taxed. *See Butler Bros.*, 315 U.S. at 507, 86 L. Ed. at 996. Polaroid has failed to provide such evidence.

Finally, North Carolina can constitutionally tax Polaroid's recovery from the Kodak lawsuit under the unitary business principle. According to the unitary business principle, a state may tax a corporation on an apportionable share of the multistate business carried on in part in the taxing state. *See Allied-Signal, Inc.*, 504 U.S. at 778, 119 L. Ed. 2d at 546. In order to exclude certain income from the apportionment formula, the corporation must prove that the income was earned in the course of activities unrelated to those carried out in the taxing State." *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 223, 65 L. Ed. 2d 66, 81 (1980). For example, a state may include within a nondomiciliary corporation's apportionable income interest earned on deposits in a bank located outside of the state, if that income forms part of the corporation's working capital. *See Allied-Signal, Inc.*, 504 U.S. at 777-78, 119 L. Ed. 2d at 546-47.

In this case, Polaroid's judgment from the Kodak lawsuit constitutes income earned from activities related to North Carolina. The judgment partly represents profits, which Polaroid would have earned absent Kodak's infringement. Those profits would have properly been considered apportionable income had they been earned in the normal manner. The fact that they were received in the courtroom instead of the marketplace is irrelevant. Moreover, the monies received from the Kodak lawsuit were used as part of Polaroid's working capital and therefore constitute part of Polaroid's unitary business. Therefore, North Carolina acted within its constitutional rights by classifying the Kodak judgment as business income and taxing it accordingly.

IV. CONCLUSION

We conclude that the definition of business income under the North Carolina Corporate Income Tax Act includes the functional test. This ruling is based upon canons of statutory construction, pertinent administrative rules, and the legislative history surrounding both the Act itself and UDITPA. Moreover, given that Polaroid's recovery constituted income in lieu of profits, that income should be classified as business income because it represents the disposition of assets integral to Polaroid's regular trade or business operations. Lastly, under United States Supreme Court jurisprudence, we conclude that subjecting Polaroid's recovery from the Kodak lawsuit to North Carolina income tax is constitutional under the unitary business principle.

REVERSED

APPENDIX B

NORTH CAROLINA COURT OF APPEALS

NO. COA97-476

FILED: 20 JANUARY, 1998

POLAROID CORPORATION,

Plaintiff

v.

MURIEL K. OFFERMAN, SECRETARY OF REVENUE,

Defendant

Appeal by plaintiff from order entered 28 February 1997 by Judge Narley L. Cashwell in Wake County Superior Court. Heard in the Court of Appeals 4 December 1997.

Womble Carlyle Sandridge & Rice, PLLC, by Jasper L. Cummings, Jr., for plaintiff appellant.

Attorney General Michael F. Easley, by Assistant Attorney General Kay Linn Miller Hobart, for defendant appellee.

SMITH, Judge.

Plaintiff Polaroid Corporation ("Polaroid"), domiciled in Massachusetts, filed this action seeking a partial tax refund pursuant to N.C. Gen. Stat. §105-267 (1989) of income tax paid to The State of North Carolina for the 1991 tax year. Polaroid requests a refund of additional assessed taxes and interest totaling $499,177.00 based on a $924,526,554.00 recovery from a patent infringement suit

Polaroid instigated in 1976 against Eastman Kodak Company ("Kodak") . See *Polaroid Corp. v. Eastman Kodak Co.*, U.S.P.Q.2d 1711 (1991).

For North Carolina corporate income tax purposes, Polaroid classified the total award from that lawsuit as "non-business income" pursuant to N.C. Gen. Stat. §105-130.4(a)(1) (1989) on its 1991 return. The North Carolina Department of Revenue ("DOR") disagreed with Polaroid's treatment of the taxes as non-business income, reclassified the damage award as business income, and assessed additional tax and interest in the amount of $499,177.00. Polaroid protested the proposed assessment and an administrative hearing was conducted before the Secretary of Revenue, who sustained the assessment. Thereafter, Polaroid paid the tax under protest and filed this action for refund pursuant to N.C. Gen. Stat. §105-241.4 (1989).

Both parties filed motions for summary judgment. On 28 February 1997, the trial court granted defendant's motion for summary judgment and denied plaintiff's motion for summary judgment. Plaintiff Polaroid appeals.

Appellate review of the grant of summary judgment is limited to two questions: (1) whether there is a genuine question of material fact, and (2) whether the moving party is entitled to judgment as a matter of law. *Gregorino v. Charlotte-Mecklenburg Hosp. Authority, 121 N.C.* App. 593, 595, 468 S.E.2d 432, 433 (1996). A motion for summary judgment should be granted if, and only if, "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that any party is entitled to a judgment as a matter of law." N.C. Gen. Stat. §1A-1, Rule 56(c) (Cum. Supp. 1996). Evidence is viewed in the light most favorable to the non-moving party with all

reasonable inferences drawn in favor of the nonmovant. *Whitley v. Cubberly,* 24 N.C. App. 204, 206-07, 210 S.E.2d 289, 291 (1974). When there is no genuine issue of fact, the existence of important or difficult questions of law is no barrier to the granting of summary judgment. *Kessing v. Rational Mortgage Corp.,* 278 N.C. 523, 534, 180 S.E.2d 823, 830 (1971).

The first issue presented for appeal is whether the trial court committed reversible error by denying Polaroid a refund of income tax it paid in 1991 on damages from the Kodak lawsuit, plus interest. Polaroid claims this recovery was not business income as defined by N.C. Gen. Stat. §105-130.4 (a)(1), or else it was not subject to taxation under the United States Constitution. N.C. Gen. Stat. §105-130.4(a) (1) defines "business income" as

> income arising from transactions and activity in the regular course of the corporation's trade or business and includes income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitute integral parts of the corporation's regular trade or business operations.

In contrast, "nonbusiness income" is defined as "all income other than business income." N.C. Gen. Stat. §105 -13 0.4 (a)(5).

"[W]hen there is doubt as to the meaning of a statute levying a tax, it is to be strictly construed against the State and in favor of the taxpayer." *In re Clayton-Marcus Co., Inc.,* 286 N.C. 215, 219, 210 S.E.2d 199, 202 (1974). This rule is only applicable when there is ambiguity in the statute. *Id.* at 219, 210 S.E.2d at 202. If the words of a definition in a statute are ambiguous, "they must be construed pursuant to the general rules of statutory construction ..." *USAIR, Inc. v.*

Faulkner, N.C. App. _____, 485 S.E.2d 847, 849 (1997) (quoting *In re Clayton-Marcus Co., Inc.*, 286 N.C. at 219-20, 210 S.E.2d at 203) . These general rules of statutory construction include giving words their common and ordinary meaning, as well as giving effect to the intent of the Legislature. *Id.*

In the instant case, Polaroid claims, in part, that business income has only one meaning, and that the phrase "and includes" in the definition merely provides examples of what fits within the definition. In contrast, DOR claims that business income has two definitions, one before the words "and includes" in the statute, and the other definition after those words. An interpretation of N.C. Gen. Stat. §105-130.4 requires us to give the phrase "and includes" its ordinary meaning.

The North Carolina Supreme Court has stated that the term "includes" does not mean "in addition to." *Miller v.* Johnston, 173 N.C. 62, 69, 91 S.E. 593, 597 (1917) Furthermore, Webster's Dictionary defines "include" as a "compromise as a discrete or subordinate part or item of a larger aggregate, group, or principle . . . ." Webster's Third New International Dictionary (1971). Therefore, the words "and includes" in N.C. Gen. Stat. 105-130.4 do not create a separate definition of business income.

Defendant DOR argues that N.C. Gen. Stat. §105-130.4 is based on the Model Tax Act and that this Act adopts a functional approach in the definition of business income. However, our statute differs from the Model Act. In the Model Act, business income can arise from two types of activities of a business, "either of which classifies an item of income as business income."

First, business income can be derived from transactions and activities that constitute the conduct of the

taxpayer's trade or business. Second, business income can be derived from a transaction involving property that does not by itself constitute the conduct of the taxpayer's trade or business, if the taxpayer holds or held its interest in the property in furtherance of the trade or business beyond the mere financial betterment of the taxpayer in general.

Exhibit D - Multistate Tax Commission - November 1994. As we have already mentioned, the language "and includes" in N.C. Gen. Stat. §105-130.4 does not mean there are two separate definitions of business income. DOR's final agency decision in the instant case asserts there are two definitions of business income based on DOR enacting regulations and issuance of a final agency decision. *See* N.C. Admin. Code tit. 2, r. 0703 (April 1991) and North Carolina Department of Revenue Final Agency Decision No. 90-37. In our interpretation we construe "and includes" to mean "and some examples are." To change the ordinary meaning of a statute, an act of the General Assembly is required. DOR may not change or amend the plain meaning of a statute by administrative regulation, final agency decision, or both.

Normally the construction of a statute is a question of law for the courts. *Wood v. J. P. Stevens & Co.*, 297 N.C. 636 642 256 S.E.2d 692, 696 (1979). Thus, whether income fits into the statutory definition of business income or non-business income would ordinarily be a question of law. However, we are aware of N*ational Service Industries, Inc.* v. Powers, 98 N.C. App. 504, 508, 391 S.E.2d 509, 512, *appeal dismissed and disc. review denied*, 327 N.C. 431, 395 S.E.2d 685 (1990), holding that whether certain income is business income is a question of fact.

In that case, plaintiff taxpayer had purchased electricity generating equipment and leased it back to the seller. There was a disputed issue of fact as to whether the purchase and subsequent lease back produced business

income, since the taxpayer was not specifically in the electricity generating business. Based on the disputed facts, the jury in that case determined that the actions of the business were done as an investment to acquire working capital and to increase cash flow, both integral parts of a business. The jury held that an investment was in the regular course of the taxpayer's business and therefore constituted business income. This Court affirmed. Thus, the classification of whether a company's action falls "within the regular course of business" for that particular company may involve a factual determination. We note that in *National Service Industries,* DOR took the position that the income generated by the leases was nonbusiness income because plaintiff was not engaged in the business of generating electricity, a position we believe is diametrically opposed to DOR's argument in the case at bar.

Once a factual determination has been made, if one is required, then the issue of whether the income falls within the definitions set out in the statute becomes one of law. *See Wood,* 297 N.C. at 640, 256 S.E.2d at 695-96. Thus, the *National Service Industries* case merely stands for the proposition that once an activity of a business has been classified through a factual determination as "in the regular course of its business," whether that income then fits the statutory definition of business income involves a question of law. Therefore, whether the income falls within the general definition of business income or non-business income set out in N.C. Gen. Stat. §105-130.4 can present a mixed question of fact and law.

In the instant case, the undisputed facts show that Polaroid is not in the business of licensing patents. Polaroid argues that, because it does not license its patents, the recovery received for patent infringement is not in the regular course of its business, such that the acquisition, management, and/or disposition of the lawsuit damages constitute integral

parts of the corporation's regular trade or business operations. Webster's Dictionary defines "regular" as "steady or uniform in course, practice, or occurrence" and further includes synonyms of the word such as "normal," "typical," and "natural." Webster's Third New International Dictionary (1971).

Unlike the National Service Industries case involving an investment, the main purpose of the Kodak lawsuit was not to acquire working capital or to increase cash flow, both activities in the regular course of business. Instead, Polaroid instigated the patent infringement suit to prevent Kodak from using Polaroid's patents and to recover lost profits. Since licensing patents to other companies is not in the regular course of Polaroid's business operations, the recovery of damages would not be in the regular course of its business. The protection of Polaroid's patents may be classified as a business activity, but it is an extraordinary event instead of an integral part of Polaroid's regular trade or business operations. Because there is no factual dispute concerning the regular course of Polaroid's business, all that remains is the statutory interpretation of the definition of business income, which is a question of law. *See Wood,* 297 N.C. at 642, 256 S.E.2d at- 696.

It follows that, since the money received is not an integral part of Polaroid's regular trade or business operations, the income derived from the damages recovery cannot properly be classified under N.C. Gen. Stat. § 105-130.4 as business income. The income derived from the Kodak lawsuit must be classified as non-business income. Thus, Polaroid is entitled to a refund.

The trial court erred by granting the summary judgment motion in favor of defendant. Although there is no genuine issue of material fact, the trial court incorrectly interpreted N.C. Gen. Stat. §105-130.4. Thus, we reverse and remand this case for entry of an order granting summary

judgment for Polaroid. In light of the foregoing reasoning, we need not address plaintiff's other assignments of error.

Reversed and remanded.

Judges MARTIN, John C., and JOHN concur.

APPENDIX C

IN THE GENERAL COURT OF JUSTICE
FOR WAKE COUNTY, NORTH CAROLINA
SUPERIOR COURT DIVISION

POLAROID CORPORATION, Plaintiff,	)	
v.	)	
	)	ORDER
MURIEL K. OFFERMAN, Secretary of Revenue of the State of North Carolina, Defendant.	)	

No. 96 CVS 763

(Filed 2/28/97)

THIS MATTER HAVING COME ON FOR HEARING before the Honorable Narley L. Cashwell, Judge Presiding, at the 9 December 1996 Civil Session of Wake County Superior Court, on cross motions for summary judgment;

AND IT APPEARING TO THE COURT that the parties have stipulated to entry of judgment out of term;

AND THE COURT HAVING REVIEWED the pleadings, answers to interrogatories, admissions and affidavits on file, and having heard the arguments of counsel;

AND IT FURTHER APPEARING that there are no genuine issues as to any material fact and that defendant is entitled to judgment as a matter of law;

IT IS THEREFORE ORDERED that plaintiff's motion for summary judgment is denied and defendant's motion for summary judgment is allowed.

This the 27th day of February, 1997.

/s/ signature
Narley L. Cashwell
Superior Court Judge Presiding

APPENDIX D

N.C. Gen. Stat. §105-130.2 provides in relevant part:

The following definitions apply in this Division:

. . .

(5c) State net income. – The taxpayer's federal taxable income as determined under the Code, adjusted as provided in G.S. 105-130.5 and, in the case of a corporation that has income from business activity that is taxable both within and without this State, allocated and apportioned to this State as provided in G.S. 105-130.4.

N.C. Gen. Stat. §105-130.3 provides in relevant part:

> A tax is imposed on the State net income of every C Corporation doing business in this State. . . .

N.C. Gen. Stat. §105-130.4 provides in relevant part:

(a) As used in this section, unless the context otherwise requires:

(1) "Business income" means income arising from transactions and activity in the regular course of the corporation's trade or business and includes income from tangible and intangible property if the acquisition,

parts of the corporation's regular trade or business operations.

. . .

(b) A corporation having income from business activity which is taxable both within and without this State shall allocate and apportion its net income or net loss as provided in this section. . . .

(c) Rents and royalties from real or tangible personal property, gains and losses, interest, dividends less the portion deductible under G.S. 105-130.7, patent and copyright royalties and other kinds of income, to the extent that they constitute nonbusiness income, less related expenses shall be allocated as provided in subsections (d) through (h) of this section.

. . .

(h) The income less related expenses from any other nonbusiness activities or investments not otherwise specified in this section is allocable to this State if the business *situs* of the activities or investments are located in this State.

(i) All business income of corporations other than public utilities and excluded corporations shall be apportioned to this State by multiplying the income

by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four.